

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM: [REDACTED]: [REDACTED]: POSTF-162245-01  
RSBloom

date: November 30, 2001

to: LM: [REDACTED]: [REDACTED]  
[REDACTED]  
Attn: [REDACTED]

from: Associate Area Counsel, LM: [REDACTED]: [REDACTED]

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subject: **Advisory Opinion: Foreign Payments - Method of Accounting**  
**Taxpayer:** [REDACTED]  
**EIN:** [REDACTED]  
**Year:** [REDACTED]  
**UIL## 267.02-03 & 267.03-02**

This memorandum responds to your request for assistance dated November 5, 2001. As requested, we have reviewed the below stated facts to determine whether the provisions of I.R.C. § 267 apply. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification.

ISSUE

Whether I.R.C. § 267(a)(3) requires the taxpayer to use the cash method of accounting when deducting amounts owed to certain "related" foreign corporations.

CONCLUSION

The "related" foreign corporations are not members of a controlled group which contains the taxpayer; therefore, section 267(a)(3) does not require the taxpayer to use the cash method of accounting when deducting amounts owed to the corporations.

FACTS

The taxpayer made payments in [REDACTED] for expenses incurred in the fiscal year ending [REDACTED]. The payments were for accrued royalty, technical assistance and salary expenses with respect to the following corporations and for the following amounts:

<u>Entity</u>	<u>Royalty</u>	<u>Tech. Assist.</u>	<u>Salary</u>
	\$	\$	\$
Total	\$	\$	\$

The "related" foreign corporations each own a percentage of the voting class A shares of stock of the taxpayer. The ownership, based upon voting stock, of the relevant corporations is as follows<sup>1</sup>:

Publicly held			
T			
%	%	%	%
%	%	%	%

The voting class A shares of stock have a per share value of \$ . The number of voting class A shares owned are as follows: - ; - ; - ; and - . Both and also own shares of class B non-voting stock of the taxpayer. The non-voting class B shares of stock have a per share value of \$ .

LAW and ANALYSIS

Section 267(a) (2) provides generally for the application of the matching principles to the treatment of expenses and interest between related persons. Specifically, any deduction allowable in respect to such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made. Treas. Reg. § 1.267(a)-3 sets forth

<sup>1</sup>There are not 5 or fewer individuals, estates or trusts that own any significant portion of the stock of each of the "related" corporations.

the rules governing when an amount owed to a related foreign person that is otherwise deductible may be deducted. Section 267(a)(3). It provides, as a general rule, that a taxpayer is required to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. Treas. Reg. § 1.267(a)-3(b)<sup>2</sup>. Therefore, if section 267(a) applies to the facts at hand, the taxpayer is not allowed a deduction with respect to the expenses in issue until its taxable year ended [REDACTED], the year during which the actual expenses were paid.

The "related" persons to which the section 267 matching principles apply are set forth in section 267(b). Of the relationships listed, the only possible relevant relationship is stated in paragraph (3), two corporations which are members of the same controlled group (as defined in subsection (f)). The term "controlled group" has the same meaning as that given it in section 1563(a), except that (1) "more than 50 percent" shall be substituted for "at least 80 percent", and (2) the determination shall be made without regard to section 1563(a)(4) and (e)(3)(C). Section 267(f). Under section 1563(a), a controlled group of corporations means any of the following groups: 1) parent-subsidiary controlled group; 2) brother-sister controlled group; and 3) combined group.<sup>3</sup>

As modified by section 267, a parent-subsidiary controlled group is one or more chains of corporations connected through stock ownership with a common parent corporation if --

(A) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and

(B) the common parent corporation owns (within the meaning of subsection (d)(1)) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned

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<sup>2</sup>There are various exceptions to this general rule; however, none are applicable to this case. Treas. Reg. § 1.267(a)-3(c).

<sup>3</sup>Section 1563(a)(4), which is not applicable for purposes of section 267, provides that certain insurance companies can be part of a controlled group of corporations. Section 267(f).

directly by such other corporations. Section 1563(a)(1). In determining whether a parent-subsidiary controlled group exists, stock owned by a corporation means (1) stock owned directly by such corporation, and (2) stock owned constructively through options, partnerships and estates or trusts. Section 1563(d)(1) and (e)(1), (2) and (3).<sup>4</sup>

As modified by section 267, a brother-sister controlled group is two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing --

(A) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of the stock of each corporation; and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Section 1563(a)(2).

In determining whether a brother-sister controlled group exists, stock owned by a person means (1) stock owned directly by such person and (2) stock owned constructively through options, partnerships, estates or trusts, corporations and family members. Section 1563(d)(2) and (e).<sup>5</sup>

A combined group consists of three or more corporations each of which is a member of a parent-subsidiary controlled group or brother-sister controlled group, and one of which is a common parent included in a parent-subsidiary controlled group and also is included in a brother-sister controlled group. Section 1563(a)(3).

Although the corporations in issue appear "related" through

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<sup>4</sup>Section 267(c) also contains attribution rules for purposes of determining the ownership of stock for section 267(b). The rules of section 267(c) are broader than those contained in section 1563. Although section 267 does not indicate whether the rules of section 267(c) should be applied with the rules of section 1563, it is the Service's position that only the rules of section 1563 should be applied in determining whether a controlled group exists for purposes of section 267. Letter Ruling 9538002 (May 16, 1995).

<sup>5</sup>See footnote 4., above.

ownership by [REDACTED],<sup>6</sup> they are not members of the same controlled group as defined in section 267(f). First, they are not members of a brother-sister controlled group. To be such a group, the corporations must be substantially owned by 5 or fewer persons who are individuals, estates or trusts. The common ownership in this case is through corporations.<sup>7</sup> Second, they are not members of a parent-subsidiary controlled group. More than 50 percent of the voting power or value of the stock of [REDACTED], [REDACTED] and [REDACTED] are not owned by one or more of the corporations in the purported group.<sup>8</sup> Finally, since the "related" corporations constitute neither a brother-sister controlled group nor a parent-subsidiary controlled group, they are not members of a combined group. Since the corporations are not members of a controlled group as defined in section 267(f), section 267(a) does not apply, and the taxpayer is not required to use the cash method of accounting when deducting the amounts owed to the "related" foreign corporations. Section 267(b).

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<sup>6</sup> [REDACTED], owns a portion of the voting stock of each of foreign corporations and, through "constructive" ownership, over 50 percent of the taxpayer ([REDACTED]: [REDACTED]%; [REDACTED]: [REDACTED]%; [REDACTED]: [REDACTED]%; and [REDACTED]: [REDACTED]%).

<sup>7</sup>Since the common ownership, as set forth in the facts above, is through corporations rather than individuals, estates or trusts, there is no need to analyze the remaining elements of the brother-sister controlled group. As noted in footnote 1., above, there are not 5 or fewer individuals, estates or trusts that own any significant portion of the stock of each of the "related" corporations.

<sup>8</sup>We are assuming that the corporations ([REDACTED], [REDACTED], [REDACTED], [REDACTED] and the taxpayer) do not own stock in one another. If this assumption is incorrect, please provide us with the information regarding their ownership in one another so we can determine whether a parent-subsidiary controlled group exists. In determining whether the required control percentage is met for the parent-subsidiary controlled group, the stock held by all the "related" corporations is taken into account.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. Also, if you have any questions regarding the above, please feel free to contact the undersigned at [REDACTED] (ext. [REDACTED]).

[REDACTED]

Area Counsel

( [REDACTED] )

By: \_\_\_\_\_

[REDACTED]

Associate Area Counsel

(Large and Mid-Size Business)